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UNCLAS SECTION 01 OF 03 SHENYANG 000194

SENSITIVE
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E.O. 12958: N/A
TAGS: ECON CH ETRD WEET PGOV PREL
SUBJECT: IN THE ZONE: COMPANIES TELL US THEIR DALIAN EXPERIENCES

¶1. (SBU) Summary: The October 26) 27 visit of officers from the U.S. International Trade Commission (USITC) to various development zones in the port city of Dalian, Liaoning Province, provided an opportunity to visit several U.S.-invested and Chinese companies, including Intel, Epoch International Enterprises, Neusoft, and Genpact. The visits suggest that Dalian's unique location, highly educated population, and infrastructure play the most important roles in the decision to invest in one or the other of the port city's well-developed zones. Intel, for example, has long-term expansion plans within the zones themselves. However, with increased competition for labor, diminishing 'other benefits,' and aggressive courting by other cities, Dalian's natural advantages have already begun to wane, and some companies have begun to look westward. This cable provides a ground-level snapshot of operations at these companies, which were reluctant to discuss important details. Septel reports on the views of the zone administrators. End Summary.

¶2. (U) October 26-27 ConGenOffs accompanied USITC officers Alexander Hammer, International Economist at the office of Economics, Country and Regional Analysis Division and Michael Anderson, Chief of the Advanced Technology and Machinery to Dalian to find out more about the differences between economic zones in China. Dalian, the major port in Northeast China, is replete with a hodge-podge of development zones that house a number of foreign and domestic companies.

INTEL

¶3. (SBU) At Fab 68, Intel's new wafer fabrication facility located in the Export Processing Zone (EPZ) James Zhang, head of PR and marketing, listed six reasons for building this, their first 12-inch wafer fabrication facility in Asia. First and foremost was Intel's interest in China as a long-term growth market. Second, Dalian has sound infrastructure, including a steady electricity and water supply. In fact, the Dalian Development Authority (DDA) built a special power sub-station for the Fab 68 to prevent any supply fluctuations. Third, Dalian's skilled labor pool and potential recruits from the 22 colleges and universities located in Dalian played a role. Intel's recent donation to the Dalian Institute of Technology, an 8-inch fabrication tool worth USD 30 million, is a bid to further attract and train promising students in the semiconductor field. Fourth, Dalian labor costs are half those in Beijing or Shanghai, with the average software-related job being RMB 2,000-3,000 (USD 293-439) per month. Fifth, twenty large Intel suppliers have already set up branches in Dalian, and Intel believes that this is a good base from which it can build up a semiconductor 'ecosystem.' Finally, the EPZ has provided Intel with numerous preferential policies. Noting

the policies are strictly confidential, Mr. Zhang said the EPZ has been "very supportive and responsive" to their needs.

¶4. (SBU) Currently, the Manufacturing Support Building houses 800 employees, but by the end of next year, Intel plans to have 1,500 employees, including 800 assembly line workers and 700 managers and office staff. Of those 1,500 employees, roughly 250 will be Americans. Intel is awaiting the conclusion of the tool installation and equipment debugging process in its Essential Utility and Fabrication Processing buildings to complete what it calls Phase One of their operation. U.S. suppliers will ship 12-inch wafers to Fab 68, which will then process the wafers and ship them to Chengdu, where they will be tested and assembled. During Phase Two of construction, slated to begin after 2010, Intel will build a testing and assembly facility in the EPZ, thereby eliminating shipments to Chengdu for after-processing. Zhang offered no word on Intel's plans for the Chengdu plant.

¶5. (SBU) Intel is the sole occupant in the 1.1-square kilometer Zone B of the EPZ. In this EPZ, set aside for manufacturing companies that export 100 percent of their product, no duties are levied on goods exported from the zone and manufacturers receive a refund on any import duties charged on materials used for exports. If the goods are sold in the domestic Chinese market, however, all related import duties are levied. Despite this incentive to export, Intel plans to sell about 80 percent of the wafers domestically. One reason Fab 68 will still be cost-effective is because of another benefit conferred on companies located in the EPZ:

it is not charged customs duties on capital equipment imports (chiefly from Japan and the United States). (Note: During earlier conversations with Intel reps, the Consul General and others were told one problem the EPZ and other municipal authorities had helped with was in obtaining these concessions on equipment that Chinese Customs might consider "used," a problem frequently encountered by foreign investors here who want to import rebuilt equipment from other factories.)

EPOCH INTERNATIONAL ENTERPRISES, INC.

¶6. (SBU) During their visit to Epoch, a wholly U.S.-owned company located in the Free Trade Zone (FTZ) since 1988, Epoch President Foad Ghalili explained how his contract manufacturing business operates in a niche market in the microelectronics sector. According to Ghalili, Epoch's unique status as an American company means it has no direct competitors in the China market: his clients expect and are assured a level of IPR protection that Chinese companies engaged in similar, small-scale manufacturing simply cannot match. As the respect for IPR has not yet improved dramatically in China, Ghalili expects continued growth. He noted that although demand for contract manufacturing decreased dramatically at the end of 2008, business has since returned to normal and total year on year profits for October 2009 have increased.

¶7. (SBU) Epoch imports about 60-70 percent of the total value of their materials; the rest is bought on the local market. Although Epoch has to pay the 17-percent value-added tax (VAT) on the locally purchased materials, any VAT paid on materials used in exported products is later refunded. (Epoch exports almost all of its products.) Sixty percent of their products are shipped to Europe, 25 percent to the United States, and 15 percent elsewhere. In addition, Epoch can purchase components and raw materials from foreign companies operating in other FTZs in China and ship them to the Dalian FTZ, where they manufacture the final product, without paying any duties or taxes. Ghalili added that his company receives income tax benefits because it is considered a "high-tech" company, whereas the corporate income tax for

other foreign companies in the FTZ is 25 percent. Epoch also re-sells its used tools and equipment VAT-free on the domestic market since no VAT is levied on high-tech tools and equipment purchased from the FTZ. About 60-70 percent of EPOCH's tools and equipment are re-sold in China; the rest are re-sold internationally.

NEUSOFT

¶8. (SBU) The information fountain seemed to be closed during a visit to Neusoft, a private Chinese software company located in Dalian's High Tech Zone (HTZ). The USITC delegation received a rather cursory introduction to the company's founding and expansion plans, all of which has been reported widely. Founded in 1991 at Northeast University in Shenyang, Neusoft is the flagship company in the HTZ, which contains Neusoft Park, a commodious campus styled like a U.S. university. Phase One, as it is called, houses a domestic business R&D center, an IT training center, an international business R&D center, and a business processing outsourcing (BPO) call center. After Phases 2 and 3 are completed, the entire park will employ 30,000 people. Unlike other zones, the park also includes optional housing, which Neusoft rents to its employees for RMB 300 (USD 44) per month; the HTZ administration built a residential area for Neusoft and then rented these buildings to the company at a reduced price. The discussion gleaned no information about the company's import-export structure, tax benefits, or business relationships with other companies in the HTZ, other zones in Dalian or elsewhere, or its international clients.

GENPACT

¶9. (SBU) Established in Dalian in 2000, Genpact provided HR support for GE's business development arm before splitting from its parent in 2005. Now it operates a back-office operation and supply-chain logistics company for the Asian market. Director of Business Development Daniel Tong explained that Genpact's reasons for being in Dalian mirrored those of Intel. Lower labor costs; a large supply of educated

labor; and proximity to the Chinese, Japanese, and South Korean markets far outweighed any special incentives, such as tax breaks. Tong said, however, that one new challenge to operating in Dalian was increasing competition for highly skilled labor, which has driven up costs. This challenge, along with a growing domestic market led Genpact to expand beyond Dalian. The company has already opened a BPO center up the road in Changchun, Jilin Province. Furthermore, in response to Genpact's expressed interest in moving westward, more than ten western cities, including Chengdu and former Dalian Mayor and Liaoning Party Secretary Bo Xilai's Chongqing, are vying for its business, offering aggressive tax incentives for the company and its employees. In anticipation of the move westward, Genpact is working with western city governments to establish language training centers at their universities.

¶10. (SBU) Although still exporting most of their services, Genpact recognizes increased growth potential in a maturing domestic market. The global economic downturn made stark the need for increased efficiency at previously unchallenged behemoths, such as China Mobile, PetroChina, and Bank of China, which have seen increased competitive pressure to streamline operations. These companies are looking to outsource their back-office operations to BPOs like Genpact as a cost-cutting measure, which Tong hopes will translate into an ever-widening net of clientele.

WICKMAN